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# Varieties of Capitalism and Banking in the EU

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## Introduction

The title of this chapter might initially appear to suggest the covering of some relatively old academic ground. Banking, and in particular the 'dichotomous framing' of 'bank-based' and 'market-based' financial systems (Clift, 2007; Culpepper, 2005), have long been at the heart of the distinctions underpinning the varieties of capitalism literature. The patience of banks in bank-based systems, encouraged by the long-term relationships they form with non-financial companies (NFCs) shields NFCs from short-term market pressures. This allows, it is argued, long-term corporate investment decisions, worker involvement in company decision making, effective training schemes (apprenticeship programmes), and stable long-term employment relations, including worker retraining and cooperative wage bargaining. Essentially, strategies can be followed that yield delayed returns, rather than short-term profit maximization. In contrast, in 'market-based' systems, banks are not providers of long-term capital and do not act as bulwarks against short-term financial market pressures on NFCs. Banks are predominantly short-term lenders and NFCs rely relatively more on equity and bond markets for finance.

The patient capital banks provide in the bank-based (archetypally German) financial system comes in two forms: equity and debt. Banks are long-term holders of the equity of the NFCs with which they have relationships and on whose boards bank employees often sit. In truth, these bank shareholdings were already in decline at the time of Hall and Soskice's seminal work (2001, p.23; Jackson and Moerke, 2005). NFC cross-shareholdings and/or long-term pension fund holdings (Culpepper, 2005) of NFC equity arguably continued to have an influence, but banks now have little remaining influence as providers of long-term equity capital in Europe. In countries, such as Germany, where bank executive membership of NFC

boards has been a source of influence, such membership has also declined, albeit replaced by NFC insiders (Hackethal, Schmidt and Tyrell, 2006).

The appropriate current focus for bank – NFC interaction is therefore bank lending. For Zysman (1983), there are two central distinctions between market-based and bank-based financial systems: first, between bank loans and securities; bank-based systems have persistently high aggregate bank lending in NFC finance (Beyer and Höpner, 2003; Vitols, 2004; Deeg, 2010). Zysman (1983, p.63) makes the distinction between ‘the impersonal arm’s length dealings of capital markets’ and ‘the personal institutional ties of banks or lending institutions’. A second distinction, less commonly picked up by the subsequent literature, is between long and short-term bank lending. Patient banks in bank-based systems provide long-term loans. There are a number of assumptions implicit in Zysman’s typology, some largely unaddressed in subsequent literature, some now questionable in the context of developments in banking in recent years. The focus of this chapter is on the latter, and on three assumptions in particular. The first is that banks and banking are synonymous. Zysman recognises the existence of non-bank lenders, but rightly, given their small size when he was writing, largely ignores them. Subsequent literature on VoC has almost entirely ignored non-bank lenders; over time, and highlighted most dramatically by the financial crisis, this has become less defensible.

The second assumption is that loans are different from other types of financial instrument. ‘What makes the financial systems different is the relative importance of two types of financial markets; capital markets and loan markets’ (Zysman, 1983, p.60). Borrowing through capital markets is to borrow in a way that exposes NFCs to the pressures of market prices, reducing their ability to make long-term decisions. The loan market, however, is in this typology different. Banks make loans, priced based on their own assessment of the creditworthiness of the borrower and of the long-term profitability of the relationship between bank and NFC. Not only are market pressures on NFCs mitigated by the ‘financial power’ of the banks, but banks are willing to engage in ‘intertemporal transfers in loan pricing’ (Boot, 2000, p.13), lending at lower cost in the expectation of recompensing profit at a later date (Aoki, 1995; Aoki and Dinç, 2000; Rajan and Zingales, 2003; Aoki, Patrick and Sheard, 1995; Deeg, 1998). This widespread distinction underpins the categorization of

financial systems by considering the provision of capital to NFCs (loan, bond, or equity)<sup>1</sup> or by the relative size of bank assets, equity stock market capitalization, and outstanding private bond market issuance (e.g., Allen and Gale, 2000). Crucial to the absence of market pressures on NFCs is the fact that loans remain on bank balance sheets and are valued 'at cost' – with a value the same as when the loan was made – unless there is severe credit impairment. Loans, unlike securities, are not traded instruments, with their price moving up and down with financial market prices.

This second assumption is concerned with the asset side of bank balance sheets and how market prices have an impact on those assets. The third assumption in Zysman's framework refers to the other, liabilities, side of the balance sheet. This assumption underlies all assumptions regarding banks as providers of patient capital: that banks are able, not just willing, to perform that role. Since banks are leveraged financial institutions, their capacity to lend is dependent on their ability to borrow.<sup>2</sup> In the early 1980s, when Zysman was writing, banks, even the investment banking operations of European universal banks, 'draw their funds from [individual and NFC customer] deposits', and depositors are loyal (Zysman, 1983, p.61). These deposits could often be withdrawn on demand, but the overall volume was stable. Absent the rare event of a bank run, banks could be confident that they would have the deposits to fund long-term lending, despite the maturity mismatch. In the medium term, increased competition for deposits, and pressure from banks' own shareholders, could bring market pressures on to the banks themselves, but at this time banks in CMEs have the capacity to be patient in their lending.

This chapter explores these three core assumptions (the first briefly) in the context of developments in banking, particularly since the start of the century. The possibility of changes in banking has long been recognized in the VoC literature. Zysman encouraged future research into the impact of 'ever more elaborate financial markets' on national systems of capitalism (1983, p.281), and Hall and Soskice (albeit focusing narrowly on regulation rather than also on innovation in banking practices) observed that '[f]inancial

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<sup>1</sup> This ignores both the maturity of bank lending and financing from companies' own retained earnings. See Murinde, Agung, and Mullineux, 2004.

<sup>2</sup> On the importance of long-term financing for the ability of German banks to make long-term loans to NFCs, see Vitols, 1998.

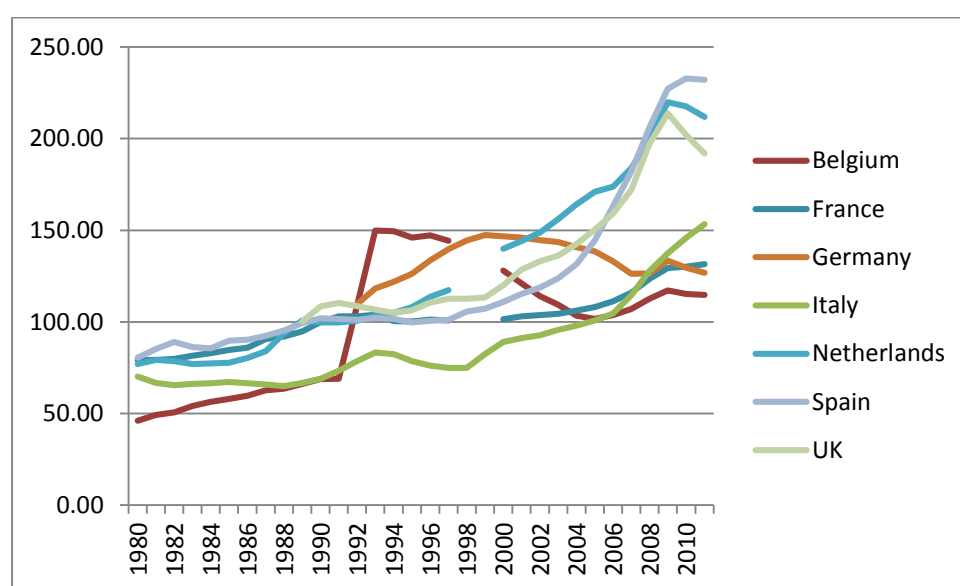
deregulation could be the string that unravels coordinated market economies' (2001, 64). These authors either recognized the static nature of their analysis (Zysman) or have been criticized for a lack of focus on processes of change (Hall and Soskice). Much of the VoC literature which followed them has indeed been centrally concerned with change, especially the extent of convergence between bank-based Continental European financial systems and their 'Anglo-Saxon' counterparts (see, for example, Berger and Dore, 1996; Crouch and Streeck, 1997; Kitschelt *et al.*, 1999; Whitley, 1999; Schmidt, 2002). The question of change in Germany has figured particularly prominently. Yet throughout, this is a literature dominated by the issue of NFC financing: are NFCs increasingly reliant on securities markets for their financing, at the expense of bank loans? This literature suffers from two fundamental weaknesses (see Hardie *et al.*, 2013; Hardie and Howarth, 2013a). First, and most important, it fails to question the fundamental dichotomy underpinning the VoC approach: the bank-based/market-based dichotomy. NFCs may (or may not – consensus has proved elusive) rely less on bank loans, but banks can still be patient and loans are different from securities. Related to this is a second weakness: a focus on the issue of convergence with an unchanging Anglo-Saxon capitalism. Change in the US and UK, the archetypal Anglo-Saxon economies, is rarely considered (although see Howell, 2007).

These weaknesses add up to a blind-spot regarding change in banks and banking. The view of banks has been very much within a narrative of disintermediation, of banks' role in the financial system reducing as securities markets become more important. There has been consideration on the response of banks, but it is focused on their contribution to this disintermediation. One of the few CPE scholars writing on banks, Deeg (2010), highlights the rise in 'deal-based banking', and the 'originate and distribute' business model. Outside CPE, the approach has been similar. Lall (2006; see also Allen and Gale, 2000) discusses traditional and 'new' financial intermediation by non-banks. Erturk and Solari (2007) show change in the sources of bank profits, away from interest on loans towards fees.

Such approaches are problematic for one simple reason. If this is the dominant issue of change with banks in recent years, the expectation must be that banks would become smaller, perhaps absolutely, but certainly relative to the size of developed world economies. An alternative measure would be a reduced role for bank lending in NFC financing. This is not what has happened. Figure 1 shows bank assets / GDP for selected EU countries since

1980. Country experiences are not all the same, and there are some breaks in the data series. However, one thing is very clear. Banks have grown in size dramatically. The story of European banking since 1980, and especially since 2000, has not been about disintermediation. The importance of banks in the intermediation of financial flows in the European economy has dramatically increased, not declined. Prior to the financial crisis, the role of banks in NFC finance relative to securities markets similarly shows banks' increasing importance, not decline (Hardie and Howarth, 2013b).

Figure 1: Bank Assets to GDP, selected EU countries, 1980-2011



Source: World Bank Global Financial Development Database

One source of this increased size of bank balance sheets has been banks buying securities or 'trading assets' (see below). Aglietta and Breton (2001, p.441) note that banks have added a 'new market portfolio' to their 'traditional credit portfolio' (see also Hardie and Howarth, 2009). Not only are banks making more loans to NFCs, but they are also becoming more important as the final purchasers of the securities whose development had been expected to result in banks' disintermediation. This would appear, on the surface, to suggest that EU economies (including the 'Anglo-Saxon' UK) were becoming more, not less, bank-based, as well as questioning the standard methodology of comparing the relative size of loan and securities markets.

This chapter does not, however, conclude that EU financial systems are becoming, more bank based. Rather, it questions these three assumptions underpinning the standard typology, as a way to consider present day financial systems and the role of banks within them. The next section examines the rise of banking activities performed by non-bank financial institutions: 'shadow banking'. The subsequent section focuses on the asset side of banks' balance sheets, and the extent to which they are subject to market forces, before a section focusing on the liability side of the balance sheet, and the changing nature of how banks finance not only their holdings of securities, but also their lending. This clear division of the two sides of the balance sheet is to some extent artificial (see discussion of the 'repo' market below), but serves a useful explanatory purpose. The aim of these two sections is to examine the 'financial power' of the banks (Zysman, 1983) through the concept of 'market-based banking'. Key to the conventional typology is banks having the power to act as bulwarks between financial markets and NFCs. This has spawned a considerable literature looking at the concentration of banks (though not banking) in individual countries, on the grounds that an oligopolistic market structure gives banks financial power (Byrne and Davis, 2003; Rajan and Zingales, 2003; Lall, 2006). I take a different view of financial power, arguing: 1) that changes in the loan markets have increasingly resulted in loans being the same as any other financial market instrument, actively traded and with the price determined in market trading; and 2) that lending is funded not only by patient depositors, but also by skittish financial market actors, whether other banks or NFCs making deposits or investors buying securities issued by the banks. The result is that the profitability of lending, and therefore its availability and pricing, is determined not by individual bank decision making but by market prices. In traditional banking, banks make decisions on lending based on their own assessment of the correct terms for that loan and with little regard to pressures on their own borrowing; that borrowing being through stable customer deposits. Increasingly, both the terms of the loan and the cost of bank borrowing are directly determined by financial market prices. We have moved, to a varied extent across European national financial systems, to 'market-based banking' (Hardie and Howarth, 2013a; Hardie *et al.*, 2013).

## **Shadow banking**

The rise of shadow banking, in various guises, is one of the central explanations given for the financial crisis (e.g., Pozsar *et al.*, 2009; Gorton, 2010; Gorton and Metrick, 2010). What these accounts highlight is the rise of credit provision by non-bank financial institutions, those entities rightly ignored by Zysman. In the crisis, the focus was on shadow banking in the US, but as regulators have increased the attention paid to this sector, the size of shadow banking in Europe has become apparent. As of end-2012, estimates from the Financial Stability Board ('FSB') put the assets of non-bank financial intermediaries in the euro area at 31 percent of the total for the jurisdictions analyzed, compared to 37 percent for the US, with the UK a further 12 percent (FSB, 2013, p.10). Euro area assets were then US\$22 trillion, and more than half the size of those of banks. The FSB regards non-bank financial intermediation as a 'conservative'<sup>3</sup> initial proxy for shadow banking.

There are nevertheless significant definitional uncertainties involved in any analysis of shadow banking. The term 'shadow banking' has been used to describe banking activity that is to a greater or lesser extent outside the commercial banking system (e.g., Pozsar *et al.*, 2009; Tucker, 2010). Of importance here is the distinction between those activities that are off balance sheet of the banks and those that are not directly connected to the banks. Some have seen these as best defined separately, as 'shadow' and 'parallel' banking respectively (Adrian and Shin, 2010; Hardie and Howarth, 2013b; Hardie *et al.*, 2013), with the term 'market-based banking' applied just to this shadow banking activity. Pozsar *et al.*, (2009, p.66) similarly differentiate between 'internal' and 'external' shadow banking and adopt a very specific definition of parallel banking related to the distinction between regulatory arbitrage and genuine competitive advantage. Gorton and Metrick (2010; also Gorton, 2010), in their focus on 'securitized banking', consider the funding of these securitized assets on the balance sheet, especially by the investment banks. However, shadow banking has been defined widely in recent debates, as policy makers seek to define banking and what should be regulated as a bank. The definition of shadow banking as 'the system of credit intermediation that involves entities and activities fully or partially outside the regular banking system' (FSB, 2013, p.5) must now be regarded as broadly accepted. An accepted

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<sup>3</sup> The FSB considers it currently covers around 90 percent of global financial system assets. Data focuses on country of domicile, and does not cover many of the offshore financial centres where much shadow banking activity is domiciled. This results in underestimation of hedge funds in particular (FSB, 2013, p.14).



definition does not remove problems of analysis, however. Much of the activity of non-bank financial intermediation is not credit intermediation (for example, equity investment funds constitute 15 percent of all non-bank financial intermediaries). A more granular analysis by the FSB of 20 jurisdictions suggests that less than two-thirds of non-bank financial intermediation can be considered shadow banking. This may change as data improves.

What is of interest to the VoC literature, and useful for cross-national comparison, may also remain somewhat at odds with the regulatory interest in the broadest data collection possible. For example, 5 percent of all non-bank financial intermediation in the FSB data, by volume, is by Dutch special financial institutions, and these entities represent around two-thirds of non-bank financial intermediation in the Netherlands. The FSB describes these entities as ‘typically owned by foreign multinationals who use these entities to attract external funding and facilitate intra-group transactions’ (2013, p.12). This is in the main multinationals issuing bonds through a Dutch subsidiary, guaranteed by the parent, and the motivation is generally avoiding withholding tax. While of interest to those focused on MNCs minimizing their tax bills, this does not represent any ‘new’ form of credit intermediation that would be of interest to analysis of financial system change. Such activity, however, results in the Netherlands having by far the highest volume of non-bank financial intermediation relative to GDP of the jurisdictions in the FSB data, in addition to representing over 15 percent of all such intermediation in the euroarea (intermediation which, as a result, is larger relative to GDP than in the US).

It is necessary, therefore, to be cautious in what we take from the recent work on shadow banking for considerations of VoC, and in particular regarding cross-national variation. We can say with confidence that non-bank credit provision increased rapidly in the years immediately preceding the financial crisis and that it has only reduced marginally since then. This is market-based financing of (amongst others) NFCs, and represents therefore secular change in the nature of NFC financing. It is change in EU financial systems as well as in the United States. We are as yet limited in the conclusions that can be drawn regarding intra-EU national variation, but the data available<sup>4</sup> is generally supportive of existing views of financial systems, with the possible exception (largely for the reasons noted above) of the

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<sup>4</sup> For the UK, Netherlands, Germany, France, Italy, Spain and Switzerland.

Netherlands. Non-bank financial intermediation is far greater, relative to GDP, in the Netherlands and UK (all over twice GDP) than in France, Germany, Spain and Italy (all under half of GDP). This is entirely as we would expect, given the overlap between the volume of non-bank financial intermediation and the size of equity and bond markets in any individual country. Moreover, there appears little reason to expect – based on currently available data – any change in financial systems' relative positions (again, with the possible exception of the Netherlands) as a result of improvements in data allowing a focus on shadow banking that is more directly relevant to comparative political economy.

A focus solely on even the narrowest areas of shadow banking, however, obscures as much as it reveals. It reveals one aspect of change while obscuring another, and for the EU in particular more important, development in financial systems: changes in the business activities of the banks themselves. Despite the very significant increase in the size of non-bank financial intermediation, it remains less than half the size of bank financial intermediation (end-2012; FSB, 2013, p.8), with shadow banking even smaller. Confining the definition of market-based banking to shadow banking largely ignores the question of market-based banks. Changes in bank activities represent a potentially more important source of systemic change in financial systems. Those changes, and the rise of market-based banks as the central part of the rise of market-based banking, are therefore the main focus of this chapter, beginning with the next section's focus on bank assets.

## **The changing nature of bank assets**

Albeit with considerable simplification, we can focus on two parts of the asset side of bank balance sheets: bank holdings of securities and bank loans. The argument for market-based banking depends on change in these three areas, evidenced by: 1) Increased bank trading assets as a percentage of total assets; and 2) the changing nature of loan markets undermining their uniqueness amongst financial instruments.<sup>5</sup>

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<sup>5</sup> Hardie *et al.* (2013) and Hardie and Howarth (2013b) focus also on banks' off balance sheet activities, especially Asset-Backed Commercial Paper. This market has collapsed, and much off balance sheet activity has moved back on bank balance sheets. Depending on regulatory developments, off balance sheet activities may once again become a key component of market-based banks.

### ***The increase in financial assets***

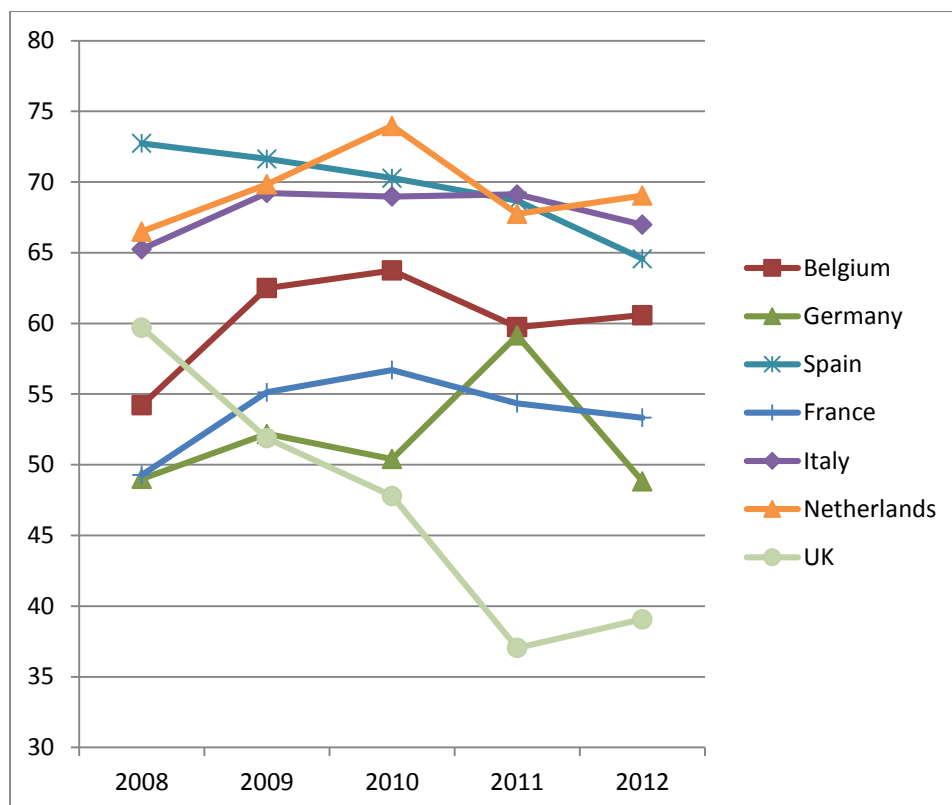
Increased financial assets – with their prices and therefore profitability determined by financial markets – represent a change in bank activities that has been acknowledged in the existing literature on financial system change, most notably in Aglietta and Breton's distinction between banks' 'new market portfolio' and 'traditional credit portfolio' (2001, 441). The innovation in this development should not be exaggerated: European universal banks have long held securities on their balance sheets (including bank holdings of NFC equity which are central to CMEs). The change is rather the significant recent increases in this 'market portfolio' and the resultant fall in loans as a proportion of bank balance sheets. These increases show the extent to which banks, on the asset side, have moved away from the view that dominates the VoC literature. Simplicity, and some data limitations, suggests measuring both loans and advances, and holdings of financial assets that are sensitive to market movements,<sup>6</sup> as a percentage of total assets, as in figures 2 and 3:

Figure 2

Loans and Advances as % of Bank Assets, Selected EU Countries, 2008-2012.

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<sup>6</sup> Financial assets held for trading, financial assets designated at fair value through the profit and loss account, and available-for-sale financial assets. This excludes financial assets designated as held to maturity, and therefore valued at the purchase cost.



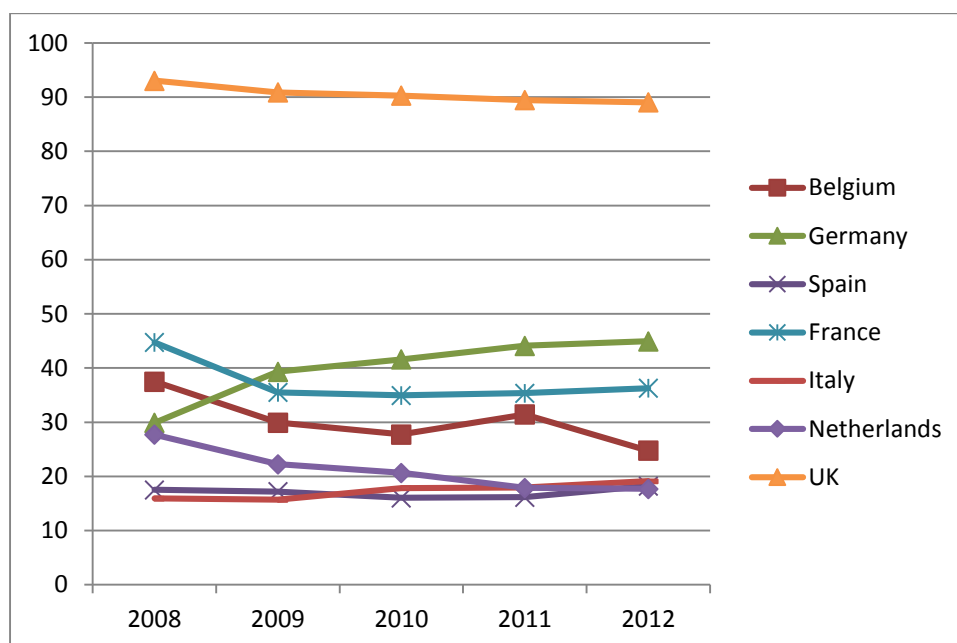
Source: ECB<sup>7</sup>

Hardie and Howarth (2009, 2013b) and Hardie *et al.* (2013) show that loans became a reduced part of commercial bank activities before the financial crisis, particularly from around 2000. An important question is whether the change represents a secular change in the nature of banks, or was rather the product of a particular period of market excess. It remains far too early to answer that question definitively, given many unresolved problems in European banking, enforced government ownership and incomplete regulatory response. Figure 2, however, does not point to any dramatic reversal of the previous trend. Loans and advances are a marginally higher proportion of bank balance sheets in 2012 compared to 2008 in four of the countries shown, but the most marked changes have been in Spain and the UK, where the proportion of loans and advances to total assets has fallen, in the UK very significantly. There is also little sign of any convergence across the countries.

Figure 3

<sup>7</sup> <https://www.ecb.europa.eu/stats/money/consolidated/html/index.en.html>, accessed 13 July 2014.

Holding of Financial Assets as % of Total Bank Assets, Selected EU Countries, 2008-2012.



Source: ECB

Figure 3 confirms this situation of little material change since the financial crisis, in the holding of financial assets. This includes financial assets held on banks' trading books, in addition to those deemed 'available for sale'. The differences between these accounting treatments are not a focus here (see Ryan, 2008; Hardie, 2011, pp.48-50), but these are assets whose price movements will have a direct impact of bank profitability or equity. They can therefore be directly contrasted with the implied conception in the existing literature of bank assets as held 'at cost', with their profitability determined only by the quality of banks' initial decision making regarding the creditworthiness of a borrower.

Any conclusions regarding secular change must also be regarded as premature with regards to this 'new market portfolio' (Aglietta and Breton, 2001), in particular because of the regulatory response to the financial crisis. This response has included various plans, at EU and national level, for 'ringfencing' commercial from investment banking in the EU, with only the former likely to receive government support. Such regulation is clearly intended to reduce the holding of financial assets, but there is likely sign in figure 3 of this change taking place yet. Even focusing narrowly on assets held on trading books, in 2012 these were more than a quarter of total bank assets in the three largest European economies, France, Germany and the UK (including in the UK, loans valued at market prices). Indeed, as

Howarth and Quaglia (2014) have argued, the nature of bank balance sheets may well, through their influence on national positions on bank regulation, have a significant influence on the limits EU regulation places on bank involvement in the buying and trading of financial assets (also Hardie and Macartney, forthcoming).

### ***The changing nature of loan markets***

Thus far, the discussion of the changing nature of bank assets has implicitly maintained Zysman's assumption that loans are a different kind of financial instrument. Hence, we can distinguish financial markets by the relative importance of loan and capital markets (Zysman, 1983, p.60). Such a distinction no longer holds. NFC loans are increasingly traded financial instruments like any other, either directly or via securitizations such as Collateralized Loan Obligations and Commercial Mortgage Backed Securities. As these loan markets become market based, this alternative source of market pressures potentially challenges a view that change has occurred only at the level of large firms, through increased issuance of equity and bonds, but not at Small and Medium-Sized Enterprises (SMEs) (on Germany, see Vitols, 2004). Loan trading is most active in the United States; Gorton (2010, p.42) sees the ratio of secondary market loan sales to outstanding commercial and industrial loans peaking in 2007 at over 25 percent. Although 'relatively nascent' (Standard & Poor's 2010, 17), European markets had trading volumes in 2007 of US\$225 billion (Axa Investment Managers, undated). The comparative importance of securitization between the US and Europe is similar. Although the US securitization market is far greater, European securitization reached US\$453 billion equivalent by the crisis (European Securitisation Forum, 2008; see also ECB, 2009, p.10), and both the Bank of England and the European Central Bank have joined the Federal Reserve in supporting securitization markets post-crisis, seeing such support as vital to improving the ability of NFCs to borrow (Cheun, von Köppen-Mertes, and Weller, 2009; on the link between securitization and credit growth, see Jiangli and Pisker, 2008; Sabry and Okongwu, 2009). Securitization is central to a decline in banks' financial power to limit the impact of the market on their clients (see Rajan and Zingales, 2003, p.8). In securitization, not only is the pricing and availability of financing determined by the market, but the ability of banks to coordinate the rescue of companies in difficulty (Zysman, 1983, p.64) is further undermined. The increasing use of Credit Default Swaps to trade and hedge corporate credit risk has

contributed further to the extent to which the profitability of NFC lending, and therefore the decision on whether to lend and the interest rate to charge, has become determined not by bank decision-making but by market prices. When banks are 'originating to distribute' – making loans in anticipation of selling them via securitization, the pricing of the loan is determined by the anticipated price for which it can be subsequently sold. The availability of loans to NFCs therefore becomes set by the price at which they will be bought by financial market actors other than banks, or at which banks packaging them into securitization products will buy them. Market prices increase/decrease profitability, increasing/decreasing the ability to retain earnings to increase capital (Deutsche Bundesbank, 2009, p.60), and, through the impact of profitability on bank share prices, increasing/decreasing the ability to raise new capital. Through 'value at risk' valuation of marked to market assets, increased volatility also increases the amount of capital banks require (Deutsche Bundesbank, 2009, p.50; Commission Bancaire, 2009, p.23). The issue, however, is not solely one of losses but is also a matter of procyclicality, as higher market prices can also increase profitability and lending capacity (Hellwig, 2009, p.180; IMF, 2008).

The question of cyclical versus secular change is also important with respect to these developments. The picture is mixed. Securitization markets have seen major falls in volume, especially in Europe (excluding securitization to provide collateral for borrowing from the ECB) and some more esoteric financial products seem unlikely to return in anything like their previous form. The importance central banks attach to restarting certain forms of securitization, however, strongly suggests that this form of market-based lending will continue to be important. In the direct trading of loans, meanwhile, there have been a number of important developments. European secondary market trading volumes are down significantly, with quarterly volumes by the end of 2012 recovering to only a third of their 2007 peak, according to one market estimate (Markit, 2013). Such a significant fall – to volumes which represent a tiny fraction of NFC lending in Europe – obscures some significant developments which point also to significant secular change.

First, the trading of loans is no longer confined to 'leveraged' or non-investment grade loans. The initial development of this market, in both the US and Europe, was very much focused on this section of NFCs. However, as of the last quarter of 2012, the rapidly expanding trading of investment grade loans made up 21 percent of European loan trading

(Markit, 2013), suggesting a fuller range of NFC loans are being traded. Second, and more significant, institutional investors have been moving into the gap created by banks' difficulties, establishing loan funds to invest in loan markets. In 2012, banks only made up 52 percent of the primary leveraged loan market in Europe (*Forbes*, 21 January 2014). With many of these loans not being traded (but still priced at market-driven yields), these developments will not show fully in data on secondary market trading.<sup>8</sup> Third, the regulatory attempts to move CDS trading onto exchanges will be likely to increase the visibility of these derivatives as the benchmark for pricing NFC credit in both bond and loan markets, thereby increasing the market element in loan pricing.

Changes in the securitization and trading of loans in Europe are not as yet at the levels of the United States, even in the United Kingdom, and there has been a significant reduction in this activity since the financial crisis. Nevertheless, even at the current levels, it is clear that these developments undermine the stark distinction between loans and securities markets. It is possible to distinguish financial systems by the extent to which these changes have occurred, but it is no longer possible to justify the (empirically simpler) typology using the comparative size of loan and securities markets.

## **The Changing Nature of Bank Liabilities**

Changes in banks are not confined to just one side of their balance sheets. Market-based banking can be seen also in bank liabilities, and in particular in the way customer deposits have become a smaller component of bank borrowing. A 'traditional' bank borrows the money it lends from its customers through their deposits. Any holdings of securities are similarly financed by deposits (Zysman, 1983, p.61). These depositors, even if their deposits can be withdrawn at any time, tend to be themselves patient. A bank run is possible, but, until Northern Rock in the UK in 2008, there had not been such a run in the UK since the nineteenth century. Furthermore, government guarantees to smaller depositors quickly returned depositors to their previous patience. As a result, banks funded by deposits do not face market pressures from this source to reduce lending or increase its cost (although note

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<sup>8</sup> Post-crisis, trading volumes in most financial instruments have fallen, as banks have been less willing to support secondary trading. Secondary loan trading volume needs to be viewed in this context.



the role of increased competition discussed above). In contrast, banks financed through financial markets, including, importantly, from other banks,<sup>9</sup> face the possibility that these 'skittish' investors can withdraw almost instantly (see, for example, Basel Committee of Banking Supervision, 2008, p.2). At the extreme, such as Northern Rock, this is the initial source of problems which lead to collapse.

The liability side of the balance sheet has moved far from the traditional conception of bank lending funded by customer deposits. First, as discussed by Gorton and Metrick (2010; also Gorton, 2009) in the case of 'securitized banking', holdings of financial assets are financed on a very short-term secured basis in the repurchase, or 'repo' market. The problems in this market have been well documented elsewhere in the case of the US, but were also significant in Europe. By August 2008, outstanding euro area repos totaled €6 trillion, 70 percent of GDP (Gabor, 2012, p.17). The market sensitivity and procyclicality of market-based assets are compounded when these assets are financed, as the vast majority are, by borrowing on a very short-term basis collateralised by the assets themselves. This is particularly the case in shadow banking by the investment banks. The importance of the repo market is highlighted by the analysis of the crisis in the US as a 'run on repo' (Gorton and Metrick, 2010; see also Acharya *et al.*, 2010). The focus of these studies on the repo market serves to highlight that market-based assets are most commonly financed with market-based liabilities, and further shows the difficulties of seeking to disentangle the two sides of bank balance sheets. Although the securities financed in the European repo market include many unrelated to NFC lending (especially government securities), bonds issued by NFCs are also significant (Gabor, 2012, p.19).

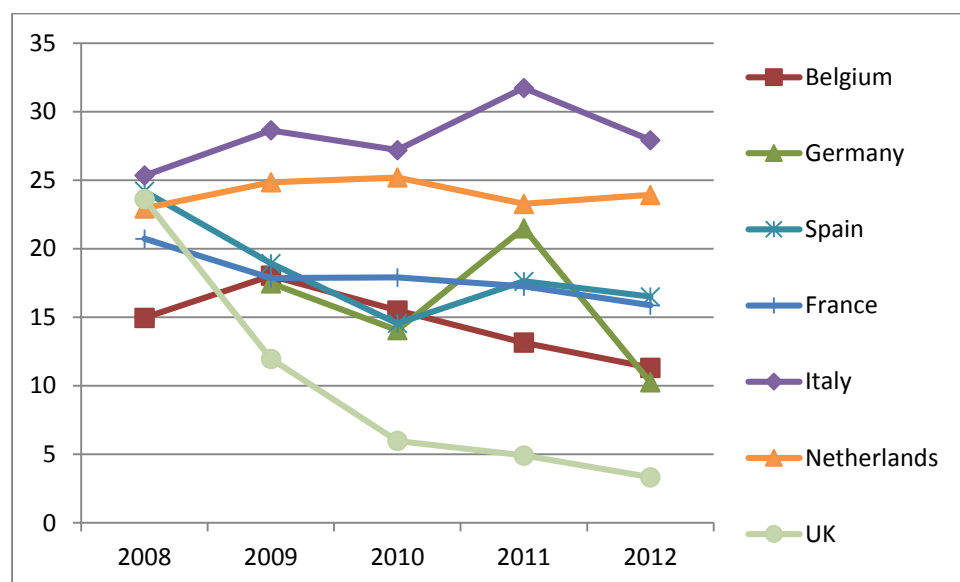
The second important area of market-based bank liabilities is in the financing of their customer lending activity. Very few banks have customer deposits equal to, or in excess of, their customer loans, creating a customer funding gap which can only be financed by borrowing from market sources (Bank of England, 2009, p.37; ECB, 2009, p.9; Raddatz, 2010). Financial market conditions have a direct impact on lending as a result. Kroszner, Laeven, and Klingebiel (2007) show how credit-dependent sectors grow faster in normal times and are hit harder in tough times, while Ivashina and Scharfstein, 2009; see also Basel Committee on

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<sup>9</sup> Byrne and Davis, 2003, p.156, show the increasing importance of interbank lending from 1970 to 2000.

Banking Supervision, 2008, p.11) show that banks with higher customer deposits (and therefore less market based) reduced lending less during the financial crisis. Figure 4 sets out the size of that customer funding gap as a percentage of total bank assets, across the countries considered in this chapter:

Figure 4: Customer Funding Gap,<sup>10</sup> selected EU countries, 2008-2012.



Source: ECB

These developments can also be placed in a longer term context: from 1980 to 2000, deposits represented a declining share of bank liabilities in G7 countries except Japan (unchanged) and France (Byrne and Davis, 2003, p.159),<sup>11</sup> and this continued until the financial crisis (Hardie and Howarth, 2013b). In order to lend, banks have always needed to borrow;<sup>12</sup> at issue is the nature of that borrowing. To varying degrees across the countries considered here, by the financial crisis a large proportion of that borrowing was not from deposits, but through sources such as the interbank market (short-term borrowing from other banks), bonds issues or securitization. As a result, banks' ability to lend is heavily influenced by their own market access, limiting the 'financial power' that can shield NFCs from market pressures. This development is recognized in central bank surveys of lending conditions for NFCs: EU banks

<sup>10</sup> Calculated as total loans and advances less total deposits other than those from credit institutions, all banks.

<sup>11</sup> Increasing interbank deposits means customer deposits declined even more (Byrne and Davis, 2003, p.155).

<sup>12</sup> Including borrowing from the central bank, involving liquidity support in a crisis.

are now asked about 'the cost and availability of [their own] funding' as an influence on lending to NFCs. This is a question the traditional conception of banks could not envisage being asked.

The customer funding gap for banks in the countries considered here increased in the years before the financial crisis, with the exception of Germany (Hardie and Howarth, 2013b; Hardie *et al.*, 2013). As a result, market forces became more influential on lending. Figure 4 shows that the situation post-crisis is slightly more mixed. The funding gap has fallen, 2008-2012, in five of the seven countries, most dramatically in the UK. Overall, this is a clear reversal of the previous trend. However, it is only (with the exception of the UK) a partial reversal. Financial market financing of NFC lending remains substantial in Europe, including in countries generally seen as bank-based.

The caveat regarding premature conclusions regarding post-crisis banks applies in this area also. Some contraction of market financing of lending after 2008 was to be expected, but the situation when European banks finally overcome their problems remains highly uncertain. However, even if banks did shrink their lending sufficiently for customer loans to be anything like equal to customer deposits, the result could only be even greater increases in the size of shadow banking, and therefore continued growth of market-based banking. Anyway, the change in banking practices would be too great. When the funding gap on loans and the financing of securities is combined, the IMF (2010, p.67) estimates UK banks total market financing at over \$4 trillion (146 per cent of GDP) by end 2007. Separate country figures for the Euro area are not given, but the Euro area total is US\$12.4 billion (94 percent of Euro area GDP). Short-term (up to 1 year) bank market funding, the most immediate source of market pressure on bank lending, represented 65 per cent of UK GDP and 54 per cent of the Euro area (IMF, 2010, p.67; in comparison, the US figure is 'only' 32 percent).

Any full analysis of the market pressures on banks as a result of financial market funding requires a more detailed consideration of the various sources of that funding. This is also necessary for any sensible comparison across countries. Empirically, this is challenging, as it involves an understanding of very similar markets in different countries. Both Italian and German banks, for example, rely relatively heavily on issuing unsecured bonds as a means of funding. In both cases, however, the nature of the purchasers of those bonds – the banks'

own individual or savings bank customers – makes this a more stable source of borrowing than bonds sold to a broad range of institutional investors (e.g., Westdeutsche Landesbank, 2009, p.97; Bayerische Landesbank, 2009, p.33; Pagoulatos and Quaglia, 2013, p.186). Similarly, banks in a number of countries issue covered bonds, a particular form of secured bond.<sup>13</sup> However, this market is longer-established and more stable in Germany (*Pfandbriefe*) than in other countries. A state guarantee on mortgages also makes Dutch securitizations more stable (Chang and Jones, 2013, p.83). Any fuller attempt to outline these distinctions is beyond the scope of this chapter (for further discussion, see Hardie and Howarth, 2013a; Hardie *et al.*, 2013). The bank funding markets can however, as an initial analysis, be distinguished in three ways. First, by the maturity of borrowing; shorter maturity liabilities, including borrowing from other banks, transmit market problems to banks' financing more quickly. The majority of unsecured interbank borrowing is short term, often for less than a week (Bank of England, 2007, p.34). Banks reliant on longer-term sources of funding (for example, Germany), such as various forms of bonds, face less immediate refinancing pressures. Second, wholesale markets must be distinguished by their fragility: the financial crisis has demonstrated that some wholesale markets are more fragile than others (Hardie, *et al.*, 2013; ECB, 2009, p.11), making the impact on lending of market difficulties more immediate for those systems more dependent on those markets. Third (and empirically most difficult), market borrowing can be distinguished by who is being borrowed from – by the type of investor. Individual investors buying bonds may be largely indistinguishable in their behaviour from individual depositors. Borrowing from other banks has proved especially skittish, with borrowing from international banks and especially in foreign currencies particularly vulnerable in the event of market weakness. Institutional investors are also generally likely to exit. Overall, however, it must be recognized that exposure to financial market funding generally goes hand-in-hand with financing from less stable sources.

## **The Implications of Market-Based Banking for Varieties of Capitalism**

This chapter has argued that the nature of banks and banking has undergone such profound change that the underpinning of the bank-based/market-based dichotomy has disappeared. Although there is no simple correspondence between typologies of financial systems and

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<sup>13</sup> For further detail, see IMF, 2009, p.90.

modes of capitalism (Deeg, 2010), this clearly has significant implications for the varieties of capitalism literature. As noted above, Hall and Soskice (2001) already saw the potential for change in banks to undermine CMEs, which depend on bank-based finance. If banks are just another group of financial market actors, as influenced by market prices as any others, it might appear sensible to consider an end to the long-running debates on convergence of CMEs with the LMEs. For VoC, if such a view is accepted, either a financial system underpinning of CMEs was always incorrect, or much of the VoC literature is in danger of finding itself in a cul de sac.

That is not the view taken in this chapter, for two reasons. First, considerable national variation in market-based banking remains, as the data presented above clearly show. In a number of the European countries discussed here, a significant amount of ‘traditional’ banking – loans to NFCs which remain on the banks’ balance sheets, funded by customer deposits – remains. The extent of market-based banking is in itself a source of national variation. The post-crisis regulatory response could be as likely to heighten this variation as reduce it, though that must remain supposition at the time of writing (November 2015).

In terms of the direction of research, central bank desires to support securitization and the FSB’s focus on a future for ‘market-based finance’ (Carney, FT.com, 16 June 2014) may point in another direction. While closer attention to the nature of banking in developed economies is overdue for comparative political economy, a research agenda considering the extent of national system moves from traditional to market-based banking should not be the main focus of future research on financial systems. A further, more promising, approach involves abandoning the existing dichotomy, and questioning the homogeneity not only of bank-based finance, but also of market-based. The underlying logic of patient capital protecting NFCs from short-term market pressures is maintained, but the assumption of banks as necessarily the only, or even the predominant, source of patient capital is abandoned. CPE has made small steps in that direction already: NFCs’ long-term holding of each other’s equity, for example, has long been central to financial systems in certain CMEs, and pension funds have been seen as a potential replacement for banks as patient owners of NFC equity (e.g., Culpepper, 2005). There is much further to go, with a research agenda targeted across the range of financial market providers of capital to NFCs. Such an agenda would require fundamental questioning of a number of the basic assumptions in the VoC

literature. For example, does patient capital require a relationship between NFC and the provider of capital? What is the nature of market pressures on lenders? What is the role of voice versus exit? The list of potential questions is long, and the implications of the answers may well lead CPE to a very different conception of the varieties of financial systems.

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